

Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations,
Title 18, Section 133, *Business Inventory Exemption*

SPECIFIC PURPOSE AND NECESSITY

Current Law

California Constitution, article XIII, section 1 provides that, unless otherwise provided by the California Constitution or by the laws of the United States, all property is taxable. (See also Rev. & Tax. Code, § 201.) All property includes tangible personal property. However, Revenue and Taxation Code (RTC) section 219 provides that, “For the 1980-81 fiscal year and fiscal years thereafter, business inventories are exempt from taxation and the assessor shall not assess business inventories.”

Under Government Code section 15606, subdivision (c), the State Board of Equalization (Board) is authorized to prescribe rules and regulations to govern local boards of equalization and assessment appeals boards when equalizing and county assessors when assessing. Government Code section 15606, subdivision (f) authorizes the Board to prescribe “rules, regulations, instructions, and forms relating to classifications of kinds of property and evaluation procedures.” The Board adopted California Code of Regulations, title 18, section (Property Tax Rule) 133, *Business Inventory Exemption*, pursuant to Government Code section 15606, to implement, interpret, and make specific the provisions, under article XIII of the California Constitution and the Revenue and Taxation Code, applicable to the exemption of business inventories.

In particular, Property Tax Rule 133 implements, interprets, and makes specific RTC sections 129 and 219. RTC section 129 defines “business inventories” as follows:

“Business inventories” shall include goods intended for sale or lease in the ordinary course of business and shall include raw materials and work in process with respect to such goods. “Business inventories” shall also include animals and crops held primarily for sale or lease, or animals used in the production of food or fiber and feed for such animals.

“Business inventories” shall not include any goods actually leased or rented on the lien date nor shall “business inventories” include business machinery or equipment or office furniture, machines or equipment, except when such property is held for sale or lease in the ordinary course of business. “Business inventories” shall not include any item held for lease which has been or is intended to be used by the lessor prior to or subsequent to the lease. “Business inventories” shall not include goods intended for sale or lease in the ordinary course of business which cannot

be legally sold or leased in this state. If goods which cannot be legally sold or leased are not reported by the taxpayer pursuant to Section 441, it shall be conclusively presumed that the value of the goods when discovered is the value of the goods on the preceding lien date.

“Business inventories” shall also include goods held by a licensed contractor and not yet incorporated into real property.

As relevant here, subdivision (a)(1) of Property Tax Rule 133 further defines the term “business inventories” and also defines the phrases “ordinary course of business” and “goods intended for sale or lease,” as used in RTC section 129. The Board added the current provisions of subdivision (a)(2)(A), (C), and (D) to Property Tax Rule 133, in 2000, in order to provide a list of the specific types of property that the Board had previously determined are included within the meaning of the term “business inventories” prior to 2000. And, the Board added subdivision (a)(2)(B) to Property Tax Rule 133, in 2000, to clarify that the Board had recently determined that new and used oak barrels are business inventories, under specific circumstances.

Proposed Amendments

Need for Clarification

The transfer of control of space flight property to the federal government is required by Air Force Space Command (AFSPC).¹ AFSPC directs safety requirements for both range users and air force space command organizations and requires that control over space flight property be transferred to a federal launch safety authority for flight termination purposes upon launch.² The federal launch safety authority, in its sole discretion, may terminate the flight.³ Termination of the flight would result in destruction of the space flight property. Because the federal launch safety authority may, in its sole discretion, destroy the space flight property, all meaningful control over such property has been ceded to it.

Prior to December 2013, the Board had provided general guidance regarding the business inventory exemption and specific guidance regarding its application to various types of property; however, the previous Board guidance had not specifically discussed the

¹ Authority over space flight property launch is granted to the Air Force via the Commercial Space Launch Act of 1984, as amended in 1988 (49 U.S.C. §§ 2601-23, October 30, 1984) which grants regulatory authority over space flight property to the Department of Transportation, which through the Federal Aviation Administration Office for Commercial Space Transportation entered into an agreement with the United States Air Force regarding the implementation of procedures for commercial space transportation and range activities. (See Memorandum of Agreement Between Department of the Air Force and Federal Aviation Administration on Safety for Space Transportation and Range Activities, at https://www.faa.gov/about/office_org/headquarters_offices/ast/media/moa.pdf (as of March 18, 2014).)

² Chapters 6 and 7 of Launch Safety Requirements for Air Force Space Command Organizations, Air Force Space Command Manual 91-711 (February 1, 2007) (AFSPC Manual 91-711) provide mission flight control officers with power to issue flight termination commands.

³ AFSPC Manual 91-711, § 7.1.1.1.

application of the business inventory exemption to space flight property. By letter dated December 24, 2013, the Board's Legal Department opined that the business inventory exemption applies to space flight property fabricated and used to transport satellites and cargo to locations in outer space and over which the owner relinquishes ultimate control at launch. In the letter, the Board's Legal Department also noted that Property Tax Rule 133 should be amended to specifically address the applicability of the business inventory exemption to space flight property governed by federal statutes and regulations.

As relevant here, RTC section 129 includes as business inventory "goods intended for sale . . . in the ordinary course of business." The Property Tax Law (RTC § 50 et seq.) does not specifically define this phrase. Property Tax Rule 133, subdivision (a)(1)(A) provides, however, that, "The phrase 'ordinary course of business' . . . require[s] that the property be intended for sale or lease in accordance with the regular and usual practice and method of the business of the vendor or lessor." Due to the unique nature of the space flight industry, the determination of whether space flight property is a "good intended for sale in the ordinary course of business" must be based upon all the relevant facts and circumstances and take into account the heavy federal regulation which constrains the transfer of title of space flight property.⁴ Within that context, the Board's Legal Department determined that the transfer of control to the federal launch safety authority upon launch, for a consideration, is a "sale" and makes space flight property "goods intended for sale in the ordinary course of business" within the meaning of RTC sections 129 and 219 and Property Tax Rule 133. The Board's Legal Department also based its determination that space flight property is business inventory, under such circumstances, on that fact that it is consistent with the Sales and Use Tax Law (RTC § 6001 et seq.) as well as case law regarding the business inventory exemption from property tax.

In determining whether property qualifies as business inventory for property tax purposes, the Board's Legal Department found that courts have looked to whether sales tax is owed on transactions involving the property as an important factor in determining whether that property was in fact sold and intended for sale (i.e., was business inventory) prior to such sale. (See *Westinghouse Beverage Group v. County of San Diego* (1988) 203 Cal.App.3d 1442 (hereafter, *Westinghouse*) [soft drink manufacturer's reusable containers supplied to wholesale customers held not to be business inventory where manufacturer did not collect sales tax reimbursement⁵]; See also *Amdahl Corporation v. County of Santa Clara* (2004) 116 Cal.App.4th 604 [sales tax reimbursement not collected on rotatable spare parts – held not business inventory].) This is because sales tax is imposed on retailers and is measured by each retailer's gross receipts from each "retail

⁴ The Arms Export Control Act (AECA) (22 U.S.C. § 2778) authorizes the President to designate items as defense articles and defense services on the United States Munitions List (Munitions List) for purposes of promulgating regulations for the import and export of such articles. (22 U.S.C. § 2278, subd. (a)(1).) The Munitions List is contained in and regulated by the International Traffic in Arms Regulations (ITAR), which places a number of requirements on any company intending to export items on the Munitions List. (22 C.F.R. §§ 120-130.)

⁵ Although sales tax is imposed on retailers, retailers may collect sales tax reimbursement from their customers as provided in Sales and Use Tax Regulation 1700, *Reimbursement for Sales Tax*. (Cal. Code Regs., tit. 18, § 1700.)

sale,” which is defined as “a sale for any purpose other than resale in the regular course of business.” (RTC §§ 6006, 6007, and 6051.) And, it follows that if sales tax is owed on a transaction involving specified property that was entered into in the ordinary course of business, then the property was “sold” in a retail sale and that same property was necessarily, prior to sale, property that was “intended for sale in the ordinary course of business” (i.e., business inventory). Thus, the courts recognize that the definition of “goods intended for sale in the ordinary course of business” must have the same meaning for the same transaction, and thus the same definition is applicable to both sales and property tax. In other words, there is not one definition of inventory for sales tax purposes and a different definition of inventory for property tax purposes.

In addition, under the Sales and Use Tax Law, the term “sale” means any transfer of title to or possession of property for a consideration and the term “transfer of possession” includes those transactions found by the Board to be in lieu of a transfer of title. (RTC § 6006.) Due to the unique nature of the space flight industry, the Board’s Legal Department concluded that when a space flight property company transfers possession (control) of specified space flight property to the federal government at launch, for a consideration paid to the company by its customer, the transfer of possession is in lieu of a transfer of title. Accordingly, the transfer of space flight property to federal government control at launch, for a consideration, is a retail sale for sales tax purposes pursuant to RTC sections 6006 and 6007. And, but for a specific exemption, space flight property companies would owe sales tax on such transfers.⁶ Therefore, since for sales tax purposes, a retail sale has taken place under such circumstances, it necessarily follows that such goods, prior to sale, were intended for sale in the ordinary course of business, requiring the classifying of such property as business inventory.

Furthermore, the classification of space flight property as business inventory is also consistent with California property tax cases considering the element of control over the property in determining whether the property qualifies for the business inventory exemption. For example, in *Westinghouse, supra*, 203 Cal.App.3d 1442, the court considered syrup and CO2 containers. It held that such containers did not qualify as inventory since the seller retained control over the containers on the lien date even though the containers were in the physical possession of its customers. The court contrasted this situation with returnable bottles in which soft drinks are sold because the bottles were not within the seller’s control once sold. In *Transworld Systems v. County of Sonoma* (2000) 78 Cal.App.4th 713, 717 (hereafter, *Transworld*), the court opined that property transferred with a nonprofessional service constituted business inventory since the goods were transferred away from the business pursuant to a customer’s direction. Implicit in this reasoning is that the customer, not the business, had control, albeit indirect, of where the goods would be delivered. Also, in *Transworld*, the court explained that “[w]hile statutes granting property tax exemptions are generally construed strictly, that approach ‘does not require that the narrowest possible meaning be given to words descriptive of the exemption, for a fair and reasonable interpretation must be made of all laws, with due regard for the ordinary acceptance of the language employed and the object sought to be accomplished thereby. [Citations].’” (*Id.* at p. 716.) Therefore, based upon the heavy

⁶ RTC section 6380 exempts qualified property for use in space flight from sales and use tax.

federal regulation, which constrains the transfer of title to space flight property, and the above discussion of property and sales tax law, the Board's Legal Department concluded that space flight property to which control is ceded to the federal launch safety authority, for a consideration, is property that is intended to be sold in the ordinary course of business and is properly classified as inventory. And, as inventory, such property qualifies for the business inventory exemption under the current provisions of RTC sections 129 and 219.

Interested Parties Process and Property Tax Committee Meeting

In Letter to Assessors (LTA) 2014/004, *Property Tax Rule 133, Business Inventory Exemption*, dated January 8, 2014, the Board's Property and Special Taxes Department advised interested parties that a project had been initiated to propose revisions to Property Tax Rule 133 due to "inquiries as to whether the business inventory exemption applies to certain space flight property regulated under the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR)" (footnotes omitted). The LTA also noted the Legal Department's December 24, 2013, letter regarding space flight property (discussed above), provided a link to a redacted copy of the letter posted on the Board's website, and gave the interested parties an opportunity to provide comments and suggestions by January 31, 2014.

Board staff conducted an interested parties meeting on February 6, 2014, to discuss the proposed revisions to Property Tax Rule 133. Staff subsequently prepared Formal Issue Paper 14-002, which included as attachments the comments received in support of and in opposition to Board staff's proposed amendments to Property Tax Rule 133, and submitted it to the Board for consideration during its February 25, 2014, Property Tax Committee meeting.

In the formal issue paper, Board staff recommended that the Board amend Property Tax Rule 133 to add subdivision (a)(1)(E), to clarify that space flight property, not operationally reusable and the control over which is relinquished by the owner upon launch, qualifies for the business inventory exemption. The formal issue paper recommended that the Board propose to add the following language to Property Tax Rule 133, subdivision (a)(1):

(E) Space flight property, not operationally reusable, listed in the International Traffic in Arms Regulations on the United States Munitions List (22 CFR § 121.1), the control over which is relinquished by the owner upon launch.

(i) "Space flight" means any flight designed for suborbital, orbital, or interplanetary travel.

(ii) The phrase "control over which is relinquished by the owner upon launch" means the transfer of control to a federal launch safety authority for space flight termination purposes.

In addition, in the formal issue paper, Board staff summarized the comments in support of and in opposition to its proposed amendments to Property Tax Rule 133. Board staff responded to the comments in opposition (and those responses are hereby incorporated by reference). Board staff also specifically explained that the proposed amendments clarifying the definition of “business inventories” will not apply to “reusable” space flight property. Board staff specifically explained that its proposed amendments are “very narrowly tailored to interpret [RTC] sections 129 and 219 to include as business inventory only spaceflight property regulated by federal statutes and regulations and for which control is relinquished upon launch.” Board staff specifically explained that the proposed amendments are more limited than the exemption afforded by Assembly Bill No. (AB) 777 (2013-2014 Reg. Sess.) because Property Tax Rule 133 only applies to business inventory, while AB 777 would exempt all space flight property whether inventory or not. And, Board staff specifically explained that “[b]ecause the issue of the qualification of space flight property as exempt business inventory is one that has potential statewide significance and is interpretative of and consistent with existing statutes, it is the proper subject of rulemaking.”

At the conclusion of the Board’s discussion of Formal Issue Paper 14-002 during the February 25, 2014, Property Tax Committee meeting, the Board determined that there is an issue (or problem within the meaning of Gov. Code, § 11346.2. subd. (b)(1)) because Property Tax Rule 133 does not address the application of the business inventory exemption to space flight property, and that it is reasonably necessary to amend Property Tax Rule 133, as recommended by staff, for the specific purpose of addressing that issue. Therefore, the Board agreed with staff’s recommendation and the Board Members unanimously voted to propose the amendments to Property Tax Rule 133 recommended by staff, and requested staff to provide additional clarification regarding the “ceding of control” and additional analysis of the federal authority requiring the transfer of control, which is provided above.

The Board anticipates that the proposed amendments to Property Tax Rule 133 will promote fairness and benefit taxpayers, Board staff, and the Board, by clarifying that RTC sections 129 and 219 apply to non-reusable space flight property, the control over which is relinquished by the owner upon launch.

The proposed amendments to Property Tax Rule 133 were not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Property Tax Rule 133.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 14-002, the attachments to the issue paper, and the comments made during the Board’s discussion of the issue paper during its February 25, 2014, Property Tax Committee meeting in deciding to propose the amendments to Property Tax Rule 133 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Property Tax Rule 133 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Property Tax Rule 133 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(5) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

The proposed amendments to Property Tax Rule 133 clarify that, under current law, the business inventory exemption applies to space flight property, under specified circumstances. The proposed amendments are consistent with the current provisions of RTC sections 129 and 219 and the cases applying those sections, the current provisions of Property Tax Rule 133, and the Sales and Use Tax Law. And, the Board anticipates that the proposed amendments will promote fairness and benefit taxpayers, Board staff, and the Board, by clarifying that RTC sections 129 and 219 apply to non-reusable space flight property, the control over which is relinquished by the owner upon launch.

As a result, the Board estimates that the proposed amendments will not have a measurable economic impact on individuals and business that is in addition to whatever economic impact the enactment of RTC sections 129 and 219 has had and will have on individuals and businesses. And, the Board has determined that the proposed amendments to Property Tax Rule 133 are not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Board has estimated that the proposed amendments will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period. Also, based on the above information and all the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Property Tax Rule 133 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Property Tax Rule 133 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Property Tax Rule 133 will not affect the benefit of Property Tax Rule 133 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Property Tax Rule 133 will not have a significant adverse economic impact on business.

The proposed amendments may affect small businesses.